

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLANT**

77-6090

United States Court of Appeals

FOR THE SECOND CIRCUIT

THE CONDÉ NAST PUBLICATIONS INC.,

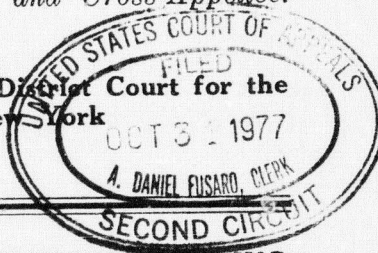
*Plaintiff-Appellee and
Cross-Appellant*

—against—

UNITED STATES OF AMERICA,

*Defendant-Appellant
and Cross-Appellee.*

On Appeal from the United States District Court for the
Southern District of New York



BRIEF FOR THE CONDÉ NAST PUBLICATIONS INC.

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BRIEF FOR THE CONDE NAST PUBLICATIONS INC.

Preliminary Statement

The United States of America appeals (161)* and The Condé Nast Publications Inc. cross-appeals (162), from the Judgment (159) and Amended Judgment (160) entered in the Office of the Clerk of the United States District Court for the Southern District of New York on

* Reference is to pages in the Joint Appendix.

March 31, 1977 and May 31, 1977 respectively, pursuant to a Stipulation of the parties (157-8) based on the Opinion and Order of Hon. John M. Cannella, U.S.D.J. dated and entered August 23, 1973 (135-56). The case was submitted to the court below upon a "Stipulation of Facts and Exhibits" (18-134) and briefs. The Opinion below has not been reported.

Issues Presented

1. Were payments received by The Condé Nast Publications Inc. (Nast) from the Butterick Company, Inc. (Butterick) in 1967 and 1968 pursuant to their License Agreement receipts from the sale of capital assets held for more than six months and subject to federal income tax in each year pursuant to 26 U.S.C. §1201 (16, 138)?

The court below necessarily found that such payments were receipts from the sale of capital assets held for more than six months and held that a portion of these receipts were entitled to capital gains treatment (154).

2. Did the court below err in holding that the portion of the annual payments which could be attributed to Butterick's sale of Vogue Patterns did not qualify for capital gains treatment?

The holding that "payments attributable to sale of Vogue Patterns are not [entitled to capital gains treatment]" was "[b]ased upon Judge Moore's opinion in *Moberg v. Commissioner*, 365 F.2d 337 (5th Cir. 1966) and the approach taken by the 1969 amendment (26 U.S.C. § 1253 (c))" (154).

Statement of the Case*

The Condé Nast Publications Inc. ("Nast") is a company which prior to 1961 was engaged in the business of publishing and printing magazines such as "Vogue", "House and Garden", "Glamour" and "Mademoiselle". In addition, Nast was in the business of designing, manufacturing and selling paper dress patterns in the United States and elsewhere in the world. In connection with its pattern business Nast made use of the trademark and trade name "Vogue", which mark and name is registered worldwide for use in connection with both patterns and publications. The Vogue patterns were "manufactured and sold in a high style and price line. . . ." (Exhibit A at 1) (25).

On January 20, 1961 Nast entered into an agreement (Exhibit A) ("Sales Agreement") (25) to sell its Vogue Pattern business to the Butterick Company, Inc. ("Butterick") as a going concern. Prior to this transaction Butterick was actively engaged in the pattern business using the trade mark and name Butterick. The Butterick patterns were "manufactured and sold in the low priced field. . . ." (Exhibit A at 1) (25).

The parties have stipulated that

[A]n essential element of the sale was the right of Butterick to continue use of the name "Vogue" in conjunction with the pattern business. No Sales Agreement would have been executed by Butterick if it did not have the right to use the Vogue name in connection with the pattern business purchased from Conde Nast. . . .

* All of the operative facts were stipulated (18) and are set forth in the Opinion (135-8). For the convenience of this Court, that portion of the Opinion is reproduced below.

Since Conde Nast was publishing VOGUE Magazine and wished to continue the use of the trademark and name "Vogue" in conjunction with its fashion magazine, a "License Agreement" was devised between the parties as part of the total Sales Agreement.

Stipulation at 2 (19).

By the terms of the contract of sale the parties agreed that on March 31, 1961, the closing date, Butterick would *inter alia*, deliver 15,000 shares of Butterick stock valued at \$225,000 and pay Nast £62,749 in Australian currency. Additionally, the parties agreed to and did in fact enter into a "License Agreement" as part of the total Sales Agreement. By the terms of this agreement Nast granted Butterick "the sole and exclusive right and license to use the trademark 'Vogue' in the United States, Canada, England and Australia" as well as anywhere else in the world it could lawfully do so in connection with its paper dress pattern business. In return, Butterick was to pay Nast a "royalty" equal to 1% of all sales of dress patterns by Butterick (including Butterick as well as Vogue Patterns) after deductions for returns and credits. The agreement was modified slightly in 1967.

From 1963 through 1966 inclusive, Nast treated the "royalty" payments received from Butterick under the License Agreement as ordinary income for federal income tax purposes. In 1967 and 1968, however, Nast claimed the right to treat these payments as capital gains rather than ordinary income. In 1972, Nast paid the Internal Revenue Service \$98,842.23 as an additional assessment for the year 1967 and \$91,534.18 as an additional assessment for the year 1968. On January 15, 1973, Nast filed a timely claim for refund of \$36,913.00 for overpayment of 1967 income taxes and \$45,865.00 for overpayment of 1968 income taxes.

Findings Below

Based upon the Stipulated Facts and Exhibits, the District Court found as follows:

1. The 1961 License Agreement contained a number of restrictions upon Butterick's use of the Vogue mark and name which can be divided into three categories: quality control, termination of the Agreement and restraints on alienation (138).

2. Each and every provision of the License Agreement which restricts Butterick's use of the Vogue name was intended primarily to protect the value and reputation of the Vogue name for its use by Nast in the publication of Vogue Magazine (143).

3. The restraints upon Butterick's use of the Vogue name contained in the License Agreement are less substantial than those found in the *Dairy Queen* contracts considered by the Tenth, Fourth, Fifth, Eighth and Ninth Circuits. In light of the fact that the Circuits which have considered an analogous situation have found sales in contracts containing greater restrictions upon the purchaser's exercise of his purchased rights, based upon the terms of the License Agreement, a sale occurred in the instant case (151).

4. The facts in the record indicated that Nast's only actual ongoing "involvement" in Butterick's business was an occasional letter regarding the use of the Vogue name by Butterick in a manner which might lead the public to believe that the product was associated with Vogue Magazine rather than Butterick's pattern business (151-2).

5. Nast's grant to Butterick of the right to continue use of the name and mark "Vogue" in the pattern business was "absolute" within the meaning of the case law, i.e., it was a sale, not a license. Nast transferred a dis-

tinnet portion of its bundle of rights regarding the Vogue name, i.e., the right to use it in the pattern business. Payment for the use of the mark Vogue does not depend entirely upon future use of the name and mark by Butterick; payment includes monies derived from the future sales of the Butterick patterns as well as the Vogue patterns (153).

6. The transfer of the Vogue mark and name for a field-of-use does not defeat capital gains treatment for the "royalty" payments from Butterick to Nast (153-4).

7. The amount of the annual payments which is attributable to sales of Vogue patterns is to be taxed as ordinary income, while that amount of the annual payments which is attributable to sales of Butterick patterns is to be taxed as capital gain (155).

Stipulation as to Butterick Pattern Sales and Judgment

In response to the direction of the court below (156), the parties stipulated as to the amount of payments attributable to pattern sales other than Vogue Pattern sales and the resulting refunds due Nast for tax years 1967 and 1968, without prejudice to the right to appeal (157-8). Judgment was entered on the Stipulation and Order and an Amended Judgment thereafter entered containing corrective language for the computation of interest.

Summary of the Argument

Nast sold its Vogue Pattern business to Butterick as a going concern. In connection with this sale, Nast transferred the right to use the Vogue name. This transfer constituted the sale of a capital asset held for more than six months. Under the applicable pre-1969 law, whether

a contract transferring trademark rights should be treated as a license rather than a sale rests on whether the transferor retained and exercised an active and continuing operational interest in the trademark and in the transferee's business.

Since the District Court correctly rejected the Government's contention that guidance in the resolution of this suit could be found in 26 U.S.C. §1253 (143), and found that the transfer of the Vogue mark was a sale of a capital asset held for more than six months, no support can be found in 26 U.S.C. §1253 or *Moberg v. Commissioner*, 365 F.2d 337 (5th Cir. 1966) or elsewhere for the holding below that the portion of the annual payments *attributable* to sales of Vogue Patterns should be taxed as ordinary income. The annual payments constitute proceeds from the sale of a capital asset and are taxable, in toto, as capital gains.

POINT I

Nast sold its Vogue Pattern business as a going concern. The transfer of the right to use the Vogue name was the sale of a capital asset held more than six months.

On March 31, 1961, Nast transferred to Butterick 100% of its pattern business—no more, but no less, than Nast had the day before. The District Court's finding that the portion of the transfer which was denominated a "License" constituted a sale for tax purposes should not be set aside unless clearly erroneous. (FRCP §52[a]; *CIR v. Duberstein*, 363 U.S. 278, 291 [1960].)

The general rule to be followed in determining whether a contract transferring trademark rights should be treated as a license or a sale rests on whether the transferor

retained and exercised an active and continuing operational interest in the trademark and in transferee's business. (*Leisure Dynamics, Inc. v. CIR*, 494 F.2d 1340, 1343 [8th Cir. 1974].)

Restrictions on Butterick's use of the name Vogue for the purpose of protecting the value of Vogue Magazine—restrictions, by the way, which were never enforced (21-2)—do not evidence “an active and continuing operational interest” in Butterick's pattern business or in the Vogue Pattern mark. Moreover, when Nast sold all of its high style and high-price pattern lines to Butterick, Nast was not concerned with the effect that Butterick's handling of the business and name Vogue would have on Nast's ability to sell subsequent “franchises” to other pattern companies or individuals. Nast was not in the licensing business; Nast was losing money in the pattern business (25), a business it could not sell without giving Butterick the right to continue using the Vogue Pattern name. Nast's prudent business desire to protect the value of Vogue Magazine cannot be transformed into any interest to control the unprofitable Vogue Pattern mark and business.

An indefinite purchase price contingent on the productivity of the assets transferred does not disqualify a bona fide transfer from constituting a sale. In cases arising in numerous contexts, it has been held that such transfers were sales. (*Burnet v. Logan*, 283 U.S. 404 [1931]; *Commissioner v. Hopkinson*, 126 F.2d 406 [2d Cir. 1942]; *Rose Marie Reid*, 26 T.C. 622 [1956], acquiesced CB 1956-2 at p. 8; *Raymond L. Allen*, 34 TCM 242, 259-260 and cases cited therein.)

Giving due consideration to the District Court's additional finding that

“each and every provision of the License Agreement which restricts Butterick's use of the Vogue

name was intended primarily to protect the value and reputation of the Vogue name for its use by Nast in the publication of the Vogue Magazine" (142-3)

it is submitted that, under the *Leisure Dynamics* test, the District Court's finding that Nast's transfer to Butterick was the sale of a capital asset held for more than 6 months was the only finding consistent with the Stipulated Facts.

POINT II

All of the annual payments should be accorded capital gains treatment.

After a thorough and detailed analysis of the Stipulated Facts and Exhibits and comparison of the License Agreement to the contracts at issue in the *Dairy Queen* cases, the District Court determined that a sale of the Vogue mark for patterns was effected. But after making this determination, the District Court, citing the opinion of Judge Moore in *Moberg v. Commissioner*, 365 F.2d 337 (5th Cir. 1966) and the "approach" of the 1969 enactment of §1253 (154-5), concluded that the annual payments *attributable* to the sale of Vogue Patterns were not entitled to capital gains treatment.

It is submitted that, though there are many tax cases where payments based on future use of a licensed product have induced courts to find that there was a license rather than a sale, *Moberg* is *apparently* the only case where capital gains treatment was denied to annual payments of the price of the sale of patent and trademark rights. In *Moberg* the Court denied capital gains treatment to a seller of "Dairy Queen" ice cream machine franchises for tied-in per gallon royalties on an ice cream

mix. The factual basis for this apparent departure in *Moberg* from the customary capital gains treatment of sales proceeds is best explained in the Supplemental Opinion of *Gowdey's Estate v. Commissioner*, 307 F.2d 816 (4th Cir. 1962). *Gowdey* construed the same "Dairy Queen" contracts considered in *Moberg*. Both cases directly involved the taxable nature of tied-in per gallon royalties on the "Dairy Queen" ice cream mix which Gowdey's licensees were obliged to purchase only from a source named and approved by Gowdey. It was ruled that the gallonage payment "was an additional charge in the form of a royalty on the 'mix used or sold'. The mix itself was not part of the sale by Gowdey to the franchisees and the gallonage payments were not a part of the consideration for the sale of the privileges." (307 F. 2d 816, 820.)

Since the gallonage payments were not proceeds from the sale of a capital asset in *Gowdey* or *Moberg*, they could not qualify for capital gains treatment and were taxed as ordinary income. As can clearly be seen here, Nast did not receive its annual payments from Butterick as "an additional charge" as in *Moberg* and *Gowdey*; the annual payments are simply the sales price for the right to use the Vogue name on patterns.

As an additional basis for its decision, the District Court relied on "the approach taken by the 1969 amendment (26 U.S.C. §1253 (c))." This amendment denies capital gains treatment to a trademark sale which is contingent on the productivity of the name transferred. However, this amendment applies to transfers made after 1969 and is not applicable to this 1961 transaction. (*Leisure Dynamics Inc. v. CIR*, 494 F.2d 1340, 1341.) Therefore, the instant case must be decided under the tax law in effect prior to the amendment, whereby a contract transferring trademark rights should be treated as a license rather than a sale only if the transferor retained and exercised

an active and continuing operational interest in the trademark and in the transferee's business. The District Court has ruled that Nast retained no such active and continuing operational interest.

The fact that Congress changed the law in 1969 to treat installment payments contingent on future productivity of the trademark as ordinary income does not give legal support to the decision below. The appellate court in *Leisure Dynamics, Inc. v. CIR*, 494 F.2d 1340, 1341 and the court below* rejected the proffered application of 26 U.S.C. §1253 as "guidance" to determine whether pre-1969 transactions were sales of licenses. Yet, the District Court, citing Senate Report No. 91-552, 91st Congress, 1st Session at 208-209 (155) relied on the statutory "approach" of §1253 to partially deny capital gains treatment to sales proceeds. However, the Senate Report referred to states that under pre-§1253 law, capital gains treatment flowed automatically from the resolution of the sale or license issue, and was not a separate and additional issue to be determined after a sale was found.

"It is difficult to resolve under present law whether the transfer of a franchise, trademark or trade name is to be treated as a sale or as a license, and whether the transferors are selling franchises, trademarks, and trade names in the ordinary course of business. *Depending upon how these questions are resolved*, the transferor will receive ordinary income or capital gains treatment on the gain he realizes on the transfer. . . . For a transaction to receive capital gains treatment, property which is transferred must generally constitute a capital asset and must be sold or exchanged." (U.S. Cong. & Adm. News 1969-2241.)

* "As the legislative history of this section makes clear, §1253 changed the earlier case law, it did not codify it" (143)

In *Moberg*, supra, the Court clearly objected to granting a franchisor capital gains treatment for annual "gallonage payments" which the Court construed to be ordinary income, regardless of the fact of an underlying sale. Here there is no set of facts, as may have existed in *Moberg*, to persuade this Court that application of capital gains treatment to the annual payments of the sales price would be improper. It is entirely appropriate to allow capital gains treatment for a sales price which is indeterminate and measured by a fixed percentage of gross receipts over an indefinite period of time. It is often difficult to determine the value of intangible property such as patents, copyrights, literary compositions and trade names and what, therefore, a fair price would be. When there is a bona fide sale, the mere fact that the purchase price may be payable in installments over a period of time does not defeat the right to capital gains treatment. (*Grinnell Corporation v. United States*, 390 F.2d 932, 948 [Ct. Cl. 1968].)

However, even if the *Moberg* result is proper in the case of a franchisor in the business of selling sub-franchises and receiving annual royalties based solely on the use or productivity of the licensed product, such a denial of capital gains treatment is not proper here. Nast is *not* in the business of selling franchises. In *Moberg* and *Gowdey*, "gallonage payments" associated with the sale of ice cream mix to be used in "Dairy Queen" machines were not payments for the right to use the "Dairy Queen" trademark, and were separate and apart from payments for the sales of the sub-franchises, and license. Here, as the District Court found, there was only one transaction. No portion of the annual payments from Butterick—attributable to the sale of Vogue Patterns, or otherwise—can be ascribed to anything other than the transfer of the Vogue Pattern name in return for 1% of the annual net sales from all Butterick patterns.

The District Court has stated in effect that if the sales price had been a percentage of net sales of Butterick patterns, other than Vogue Patterns, the entire sale price would qualify for capital gains treatment. Yet, if the sales price had been a percentage of net sales of Vogue Patterns, the entire sales price would have been ordinary income. Such a holding, that the gain from the sale of a capital asset held for more than six months was ordinary income, would have been clearly erroneous and would have to be reversed on appeal.

However, before §1253 was enacted, the determinative issue was not whether any portion of the sales price was attributable to the earnings of the capital asset sold, but it was simply whether the annual payments were receipts from the sale of a capital asset held for more than six months within the meaning of 26 U.S.C. §1201. Since this issue has been found by the Court below in favor of Nast, there is no warrant to compromise the result. Perhaps it would have been appropriate for the parties to have arrived at such a compromise, but it was error for the District Court to have imposed one.

CONCLUSION

The District Court erred in disallowing capital gains treatment for those portions of the annual payments of the sales price to Nast attributable to Butterick's sale of its Vogue Pattern line. This matter should be remanded to the District Court with instructions to enter judgment in the amounts demanded in the Complaint, together with applicable interest and costs of this appeal.

Respectfully submitted,

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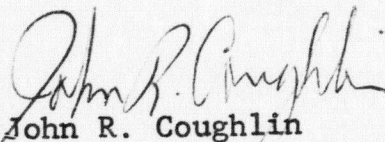
Re: The Condé Nast Publications Inc.
v. United States of America
Docket Number 77-6090

Gentlemen:

Enclosed are ten (10) copies of the Brief, and Notice of Appearance of Counsel, on behalf of The Condé Nast Publications Inc. Two (2) copies of the Brief and one (1) copy of the Notice of Appearance of Counsel have been served today upon Assistant United States Attorney William G. Ballaine with a copy of this letter.

I have been advised that the Joint Appendix has been filed by Mr. Ballaine.

Very truly yours,



John R. Coughlin

JRC/dag

Enclosures

cc w/enclosures: William G. Ballaine, Assistant
United States Attorney

